

September 27, 2011

Chairman Mary Nichols
California Air Resources Board
1001 I Street
Sacramento, CA 95814

**Comments on Proposed
15-day Modifications to the Cap & Trade Regulation**

Chairman Nichols:

This letter provides comments on the California Air Resources Board's (CARB) Proposed 15-Day Modifications to the Regulation for California Cap on Greenhouse Gas Emissions and Market-based Compliance Mechanisms (Cap and Trade Regulation) dated September 12, 2011. In summary, we recommend CARB:

1. Assign offset liability to those that are best able to manage it – the project developer and CARB
2. Increase the 8% offset limit
3. Allow for the forward carry of unused offset capacity
4. Issue multi-year allocations
5. Allow for the use of shutdowns/curtailment to generate credits

The implementation of these recommendations will:

- Improve the prospects for achieving the ambitious emission reduction goals of AB 32.
- Minimize compliance costs.
- Reduce the likelihood of leakage.
- Foster a more robust liquid emissions market that improves compliance and reductions.

Our recommendations are drawn from a depth and breadth of experience that is second to none. BGC Environmental Brokerage Services, L.P. (having acquired CantorCO2e) is the world's oldest emissions trading brokerage firm. Established in 1992 by the global financial services firm Cantor Fitzgerald, we have played key roles in the development, implementation, and refinement of nearly every important emissions trading program in the world. In addition to providing consulting and brokerage services to our clients over the years BGC Environmental Brokerage Services staff have served on, been a board member of, or chaired a number of emissions trading related groups including the **California Climate Change Advisory Committee** (appointed by the California Energy Commission), the **RECLAIM Three Year Audit Committee** (appointed by the South Coast Air Quality Management District), the **European Trading and Market Liquidity Group**, the **Emissions Trading Group** (a think-tank that was instrumental in shaping the European Emissions trading), the **Voluntary Carbon Standard** (an international body drawn up under the Climate Group), the **Environmental Markets Association**, and the **Ecosystems Marketplace**.

Based upon this experience we offer the following comments regarding the proposed regulations:
These items are discussed below.

**1. Assign offset liability to those that are best able to manage it – the project owner and CARB -
Section 95985**

Section 95985 states that users of credits which at the time of their acquisition were determined to be eligible for use that later turn out to be invalid are required to replace bad credits or suffer sanctions. CARB's offered analysis suggests that CARB believes that:

- High quality credits will naturally rise to the surface
- The interests of the market will be protected by a combination of:
 - High quality verifiers (through single or multiple verifications)
 - Sales contracts that apportion liability and provide guarantees
 - Third party insurance products

Experience gained through nearly three decades of emissions trading and the participation in dozens of environmental markets suggests that exhaustive due diligence on the part of buyers, the use of trained verifiers, cleverly written conveyance contracts, sophisticated derivative products, and privately administered insurance products will not adequately protect the interests of the buyer, preserve the integrity of the market, nor safeguard the environment.

Making the buyer liable for offset maintenance is problematic because:

- Buyers suffer sanctions and/or must replace credits that, though approved by the CARB, later turn out to be invalid
- Offset transaction and due diligence costs will be higher
- Programmatic compliance costs will be higher
- Offsets, when compared to allowances, will become second class compliance instruments
- Faced with higher costs, sources on the margin will be that much more inclined to contribute to leakage by expanding their operations and/or export jobs outside the jurisdiction of AB32
- Ignored will be important lessons gained through successful implementation of seller liability provisions in CA, US, and EU programs
- As compared to a seller liability program, the environment will not gain enhanced protection and CARB will have fewer tools to guarantee environmental protection

An approach that relies purely upon the use of high quality credit verifiers (even with multiple reviews) will not work because verifiers:

- Are not officers of the government and do not have the ability to stand in CARB's shoes when it comes to determining if the credit creating activity meets the requirements of the rules as may be subsequently determined by the CARB.
- Cannot (and are not paid to) monitor a project after the credits are claimed and/or transferred.
- Will, given the potential liabilities of lawsuits (which may ensue after the credits are transferred/used), find it very challenging to secure professional liability insurance.
- Will be unable to charge a fee that adequately compensates them for the cost of doing the initial and ongoing assessments, paying for liability insurance, and setting aside cash reserves in the event that any credits which have been reviewed by the verifier are subsequently determined to be bad.
- Will only validate only the project data that is provided them. They cannot be expected to be responsible or prescient to predict changes in operations, policy, or law that could invalidate credits in the future.

It will be difficult to write conveyance contracts in a fashion to remove buyer risk because:

- Credits may change hands many times, each time with a different buyer and seller. While demanding

performance from the initial project developer may be practical it becomes quite a different prospect when the credit has been purchased numerous times before it is used and discovered to be invalid. The cascading liabilities, multiple conveyance contracts, and the passage of time that are implicit in such a scenario will make it impossible for a buyer to gain resolution in the event of bad purchases.

- The actual credits may be divided, segmented, and conglomerated into financial instruments that allow market participants to transact products that represent emission reductions from a variety of different offset creating projects. Again, it is impractical for buyers to conduct appropriate due diligence on the offset that will make up such a derivative product. So too will it be difficult for a seller of a financial product which represents an amalgam of credits from different projects to replace just that portion that are determined to be invalid.
- There is no guarantee that buyers will be in a position to purchase replacement credits – especially if the market moves higher and/or the buyer’s financial position significantly deteriorates.

Nor should CARB conclude that the problem of offset reversals can be adequately managed through the use of insurance or financial derivative products because:

- Such products may initially reduce the risk of purchasing offsets, but the instruments will, if priced considering consequential damages, sell at prices that dramatically increase transaction costs.
- Given the plethora and magnitude of such risks, a dispassionate observer should be concerned that the insurance provider does not have the ability to understand, much less mitigate the potential financial consequences of offset reversals.

It does not have to be this way. Other offset/cap and trade programs (esp. those associated with California’s new source review programs) have effectively dealt with and eliminated risk issues by:

- Making the offset creator liable for maintaining the reduction
- Subjecting the offset creator to a permit with enforceable sanctions for non-compliance
- Requiring the offset to be verified/sanctioned by the regulator.

BGC Environmental Brokerage Services, L.P. recommends that CARB amend the language in a way that will simultaneously protect the environment, its “currency” (i.e., the offsets), and the buyer by:

- Allowing a source to secure CARB/air district review and approval of credits. Specifically, as with offsets useable for new source review, the company creating the reduction must apply to the regulator (i.e., CARB or the anointed Air District) for recognition of such reductions. Upon receipt of an application CARB should:
 - Approve those credits that satisfy AB32 criteria and protocols; or
 - Deny those that do not, and
 - Conditionally approve those credits which may be subject to revocation.

Two different kinds of credits will emerge from this process – those:

- With CARB approval (which cannot be invalidated or withdrawn – and which will sell at a premium)
- That lack CARB approval (which the buyer will be aware are at risk of revocation – and which the market will discount).
- Issuing CARB/air district permits to offset-creating sources. Such permits would be issued to sources under CARB control, would mandate the maintenance of the reductions, and sanctions for non-compliance that would have the dual effect of, in the event that the credits are not maintained:
 - Protecting the environment and
 - Penalizing (and gain recompense from) the offset creator.

- Creating an CARB-administered insurance pool that is either privately funded with credits or through a CARB administered shave that is applied to each credit issued and/or traded

2. Increase the 8% offset limit – Section 95854

Section 95854 limits the volume of offsets that facilities can use for their annual and triennial compliance obligation to only 8%, thus artificially raising the cost of compliance. This limit should be either significantly increased or eliminated.

This restriction, combined with the expected use of auctions as a means to distribute the allowances, can be expected to:

- Marginalize (render inconsequential) the use of offsets
- Reduce offset supply
- Discourage out-of-program sources that would otherwise be subject to CARB control (for it is only such sources that can create credits) from taking steps that would have otherwise be taken to reduce emissions.
- Increase the cost of compliance.

In the end, when faced with these restrictions:

- Offset creators will be more likely to choose to expend their capital in regions that allow for the greater use of offsets
- Potential offset buyers will be more likely to choose to expand – and possibly move – their operations to regions that are not burdened with such restrictions.

Surely there will be less cause to celebrate if statewide AB 32 emission reduction goals are met owing, in part, to leakage associated with sources that leave the state.

BGC Environmental Brokerage Services, L.P. recommends that CARB remove the quantitative restriction. Instead, limits should be based on quality of offset credits. Any offset credits which meet CARB's qualitative criteria should be allowed to be used by sources.

3. Allow for the carry forward of unused offset capacity – Section 95854 (a), (c)

In order to promote lower cost compliance and market efficiency CARB should allow facilities to carry forward and trade unused offset capacity.

Facilities and market participants have expressed concern that they cannot bank unutilized offset compliance requirements for use between compliance periods. In other words, as the rules are currently drafted, for example, a facility uses offsets to satisfy only 6% of their annual compliance obligation in compliance period 1, cannot:

- Bank the remaining 2% for use in compliance periods 2 and 3.
- Trade the remaining amount to other facilities.

As a means to reduce compliance costs and provide flexibility, sources should be given the ability to carry forward and trade unused offset capacity.

4. Issue multi-year allocations – Section 95910

CARB proposes to only issue allowances on a one year forward basis (not multiple years). This creates extraordinary and unnecessary uncertainty for financial and capital planning purposes. In addition, CARB is only auctioning off current year allowances and a limited amount of two year-ahead allowances, instead of multiple

years of allowances. Limited allocations and auctions makes it very difficult for new facilities/projects with traditional multi-year (e.g., 15 – 30) planning horizons. Some facilities, when faced with this uncertainty, can be expected to choose to site or expand facilities in states not subject to AB32. As a result, CARB should follow the Acid Rain and RECLAIM program examples whereby sources were issued and allowed to trade multiple years of credits.

5. Allow for the use of shutdowns/curtailment to generate credits – Section 95891

Section 95891 of the regulations indicate that facilities may not retain (nor gain) allowances if they cease operations. There is a certain logic to this provision -- *why reward facilities with revenue that can be gained from the sale of shutdown created allowances/credits?* However, depriving sources with the ability to gain revenue from the shutdown of emitting units will:

- Increase compliance costs. When streams of allowances from shutdown facilities are repatriated back to the state we can presume that they will be sold through a state sponsored auction with a minimum clearing price (\$10 in 2012) that will likely be above that which is offered on the secondary market.
- Encourage older/inefficient emitting units to stay on line. Knowing that it will forfeit its allowances and credits a source operator will be inclined to keep the source operating as long as feasible. This will have the dual effect of discouraging equipment replacement (thereby keeping inefficient sources online) and keeping credits from the market (thereby reducing supply).

As a means to mitigate costs and encourage companies to remove older and inefficient sources, CARB should allow for the creation of shutdown-derived offsets. Further, should CARB elect to issue multi-year allowance streams, companies should be allowed to retain, redeploy, or sell allowances that are no longer needed by sources that are curtailed or shutdown.

BGC Environmental Brokerage Services, L.P. thanks CARB for receiving this letter and for the opportunity to participate in this process. We look forward to participating in future discussions with the board, its members, and staff. Please do not hesitate to call us at 415-296-9359.

Respectfully,



Josh Margolis
Director

cc: James Goldstene, CARB